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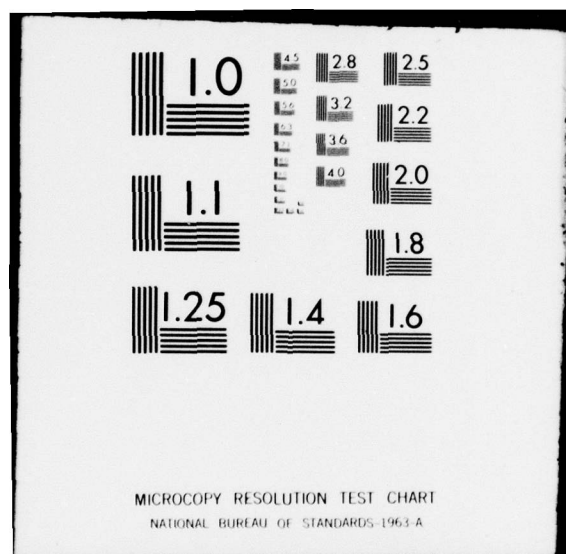
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# Can Policy Changes Be Made Acceptable to Labor?

Louis S. Jacobson

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## CAN POLICY CHANGES BE MADE ACCEPTABLE TO LABOR?

by

Louis Jacobson

### INTRODUCTION

There are many ways in which government programs could be more efficient, that is, programs could be changed to produce the same output but at a lower cost. Yet anyone who ever tries to introduce such changes soon realizes that not every one will be happy with the result; although the benefits may outweigh the cost in some aggregate sense, some people get hurt by the change.

Because some people will be hurt by actions to increase efficiency, it is often politically difficult to change an existing policy. The benefits are often widely dispersed and small per capita, while the costs, although affecting a relatively small number of individuals, are very concentrated and large per capita. The losers can frequently bring sufficient political pressure to bear to block the change.

For a technically desirable change to be politically acceptable as well, it is crucial to reduce adverse distributional effects. The most obvious way to do this is to have those who gain -- society at large -- compensate the losers. Economists frequently evaluate a change based on whether

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the gains are large enough to make compensation possible, but rarely consider what would be involved in actually providing compensation.

This paper focuses on some of the practical problems of compensation:

- who should receive it
- how much should be paid
- how should it be paid.

Several recent studies have measured earning losses of workers whose jobs have terminated. These studies examined how losses varied as a function of the age and tenure of the displaced workers and economic conditions. The findings can be used, not only for designing a compensation system, but also in choosing when to make changes such as closing government installations, reducing spending on particular products such as the B1 bomber, deregulating industry, and introducing new regulations.

#### WHO SHOULD RECEIVE COMPENSATION

The number and variety of individuals who might be hurt by a change in government policy are enormous. In the case of a tariff reduction, for example, those that will be hurt include:

- job holders in firms that face increased import competition,
- current holders of capital assets in these firms,
- workers and owners in firms supplying goods and services to firms that are directly affected,
- workers and owners in industries that produce goods or services that are substitutes for those directly affected,

- workers whose wages might be affected by competition from displaced workers or whose bargaining power may be reduced,
- government workers currently involved in administering the tariff regulations,
- other members of the communities where all the above groups reside.

With so many potential losers, it would be virtually impossible to compensate every individual who suffered a loss. The transaction costs alone would be enormous, swamping the benefits and making change undesirable. Thus, some general rules must be used to determine when compensation should be paid. Three possible bases of compensation are:

- political expediency
- legal principle
- altruism.

In practice, all three motives are important, and individuals who can establish claims on all three bases are most likely to actually receive compensation.

#### Political Expediency

Political expediency dictates that individuals who otherwise would block the change should be compensated. On this basis, compensation would go to members of well organized, politically powerful groups such as members of labor unions, trade associations, or community groups.

Those groups need not be compensated for every loss imposed on them; only large losses will be worth fighting over. Even the most powerful group can afford to use its resources to gain only a few objectives and will naturally choose issues where the potential gain is greatest.



### Legal Principle

Legal principles dictate that individuals who have been deprived of a property right should be compensated, even if they are not politically powerful. Legally defined property rights are protected through the court system; it is de facto property, to which rights have not been legally defined, that causes problems. For instance, it is not at all clear whether a firm has a "right" to existing tariff legislation, or whether a logger who used to cut redwoods in what has recently been set aside as a national park had a right to employment in that occupation, at that place.

In situations where perceptions of property rights are hazy, a sense of fairness may be the best guide to action.\* While legal scholars are still struggling with the issue, most authorities seem to agree that compensation should be paid if an individual has been significantly harmed by a government action taken in error, or if the government's action could not reasonably have been foreseen. The idea of fairness may lead to compensation of labor more than to owners of capital. The extreme flexibility of capital assets, particularly common stock, coupled with the fact that most policy changes are debated long in advance of action, tends to provide owners of capital with a reasonable opportunity to avoid loss. This contrasts sharply with the situation facing workers and operators who frequently have very specific skills. Often, their best alternative is to stay at their present jobs until

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\*Michelman suggests that "fairness" should be the ultimate determinant of compensation when such undefined cases reach courts for review: Frank I. Michelman, "Property, Utility, and Fairness: Comments on the Ethical Foundations of 'Just Compensation' Law," 80 Harvard Law Review, 1165-1258 (1968).

forced to leave. While it is not clear whether labor should assume the permanency of tariffs, particularly when organized labor has lobbied in favor of tariff legislation, workers who are hurt may be regarded as innocent bystanders injured by the change.

Since many factors influence a firm's employment and profit level, a loss should also have a clear connection to a policy change before a claim for compensation will be recognized as valid. Workers in firms that are not directly involved in the production of an affected item and workers in firms that are subject to frequent fluctuations in demand, independent of governmental action, will find it hard to get compensated for government-induced losses.

#### Altruism

Altruistic desires dictate that individuals who are regarded as worthy of social concern, regardless of legal or political consideration, should be compensated if they are hurt by a change in policy. On this basis, compensation would go to individuals who suffer large losses relative to their resource base. Low paid workers who lose their jobs and are the primary support of their families, as well as older workers who may lose pensions, are particularly likely candidates. Owners of capital entrepreneurs, and highly paid workers, even if they suffer large losses, are unlikely candidates because they often have financial reserves and general human capital that give them the ability to rebound successfully.

In the remainder of this paper I will limit the discussion to considerations of what is "fair" compensation and how compensation should be paid. I will focus on workers who permanently lose their jobs in industries directly affected by policy change (displaced workers) as the target of compensation.



Although specific loss computations will be described for this group only, it will become evident that policies designed to reduce losses by these groups will frequently minimize the losses of other groups as well.

#### HOW MUCH COMPENSATION SHOULD DISPLACED WORKERS RECEIVE?

"Fair" compensation can be defined as the amount that is sufficient to make an individual indifferent about whether or not a program change is adopted. The compensation does not have to be in the form of a single cash payment, it could be an offer of an offer of an equivalent job, for instance, or of payments over time, sufficient to maintain a worker's utility at the pre-change level.

A practical way to estimate the appropriate cash payment is to measure the monetary value of the loss. This can be done by comparing the present discounted value of an individual's income stream (including pension and fringe benefits), assuming that the program is not changed, and the present value of his income, if the change is adopted.

For some individuals the monetary loss will exceed the utility loss. This will occur, for instance, if the job was one where the worker received a positive compensating wage differential because the job was particularly onerous. Overstatement of losses will also result from the fact that a major cause of monetary loss for most individuals is unemployment. Measuring unemployment losses at the full amount of earning reductions disregards the utility value of the additional leisure, which can often be worth a lot to the worker, particularly when the individual spells of unemployment are of short duration and the search for a new job is at least partially financed by unemployment insurance.

On the other hand, the monetary loss can be less than the utility change. For example, the psychic costs of adjusting to a new work environment and the loss of friends from the old job may be large, and uncertainty about the prospects of a new job while unemployed may be quite onerous. Anything that is good about a job, whether it is a good fringe benefit or simply the security of familiar faces, may be reflected in lower wages. When wages are low, due to compensating wage differentials, the monetary loss is less than the utility loss due to displacement.

While compensating wage differentials can lead the monetary loss from displacement to be different from the utility loss, this divergence is probably not serious in practice. Analytic studies of wage determination have found that inter-industry wage differences are largely a function of differences in human capital, not of pleasant or unpleasant aspects of a job. Earnings losses caused by reductions in returns to human capital are the appropriate target of compensation programs.

To accurately estimate how much a worker would lose if he was displaced from his job by a program change requires three measurements:

- the loss in compensation, assuming the worker is forced to leave his job,
- the probability that he would have remained on the job if given the choice,
- the probability that he would not have been displaced in the future for reasons other than a change in program.

The total loss for each worker due to the change in program equals the loss in compensation times the sum of the two

probabilities.\* The total loss will be larger, the larger is the earnings loss due to displacement. It will also be larger, the smaller is the probability that the worker would have left in the future, either voluntarily or involuntarily.

#### Earnings Loss and Attrition

A study recently completed at the Public Research Institute examines the first two components of losses for workers in a diverse group of industries.\*\* The study shows that the average cash loss per displaced worker varied a great deal across industries. The per capita loss was high in high wage industries such as steel, aerospace, and autos: workers in those industries lost an amount equal to about a year of pre-separation earnings, over the five years following separation. In low-wage industries such as those manufacturing shoes, TV receivers and cotton textiles, the average earnings of displaced workers fell by less than 5 percent a year, and most of that loss was associated with unemployment during the first few months following separation.\*\*\*

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\*If the two probabilities are not independent, the product must be subtracted from the sum.

\*\*See Jacobson, Louis S., "Earnings Losses of Workers Displaced from Manufacturing Industries," Public Research Institute, PP 169, Nov. 1976.

\*\*\*These estimates are for earnings loss only. Severance pay is included; other forms of compensation and fringe benefits are omitted. For most of the workers unemployment insurance receipts probably exceeded the value of lost fringes. Unemployment benefits would have reduced losses substantially in the low wage industries.

The overall rate of attrition - the rate at which workers leave an industry when employment in the industry is stable - affects the per capita loss that must be compensated. To the extent that each displaced worker would have left anyway, the loss cannot be attributed to the policy change.

With respect to the probability that a worker would have left in the absence of a policy change, the study found that workers with large per capita losses also had a low probability of leaving otherwise, and vice versa. This is a very reasonable result since anticipation of large monetary loss should be expected to severely inhibit quitting.

The attrition rate not only affects the loss per worker but also the number of workers who experience any loss. Assume that a policy change requires a specific employment reduction. To the extent that a firm can reduce employment without laying off workers, the total number of displacements will be reduced. In addition, most firms lay off workers by seniority, following a last-hired, first-fired policy. Thus, a reduction in the number of displacements also reduces the average tenure of those displaced. Since low-tenure workers often have relatively small per capita losses,\* the aggregate loss is reduced more than proportionately with an increase in the attrition rate.

The attrition rate varies a great deal among industries. In low-wage industries, the rate is frequently three times as

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\*These results were demonstrated in detail for steel workers and were shown to be generally valid by unpublished regressions. See Jacobson, Louis S., "Earnings Losses and Worker Displacement when Employment Declines in the Steel Industry," Ph. D. Dissertation, Northwestern University, August 1977.



high as it is in high-wage industries. This means that a given employment decline will require many fewer displacements in the low wage industries, and the total loss will be many times less.

There is some evidence that these differences in displacement losses have been taken into account in making changes in trade policy. Over the past several years, more protection has been offered to workers in high wage industries, such as steel, than in low wage industries, such as shoe manufacturing.

#### Factors Affecting Earning Loss

The study of workers displaced from the steel industry, cited above, showed that losses depend on:

- the level of unemployment in the local labor market when the worker was displaced,
- prior employment trends in the industry,
- how a given employment reduction is distributed across firms in the industry.

#### Unemployment Rates

A high level of local unemployment at the time of displacement increases the loss per displaced worker. The study of steel workers found that an increase in the local labor market unemployment rate from 4.1% to 5.5% doubles the first year loss. Unemployment rates have a strong effect on losses because at least half of a displaced worker's earnings loss is due to unemployment rather than to his receiving reduced wages on a subsequent job.

### Prior Employment Trends

An employment reduction will result in relatively small losses if it follows a period when the firm has been growing. Employment growth implies that a high percentage of employers are workers with low seniority, who characteristically have unusually high attrition rates. Since voluntary attrition can be counted on to reduce employment, an employment reduction following a period of expansion will result in far fewer workers being displaced. The difference can be very large: attrition rates vary by as much as 2 percentage points due to differences in the industry's seniority structure.

### Distribution of Employment Reductions

If employment reductions are unevenly distributed across plants, that is, if some plants shutdown completely while others do not displace workers, losses will be relatively high. Primarily, this is because attrition can not substitute for displacements when a firm shuts down. High tenure workers who have large losses will be displaced, and the local area will be flooded with many workers with similar skills. To make matters worse, shutdowns often occur in older plants located in declining areas where unemployment is already high.

### Future Displacement

The third component of the loss calculation, the probability that a worker will be forced out of a job even in the absence of a policy change, is likely to have a major impact on the size of the loss. Unfortunately, this probability is extremely difficult to measure accurately.



Many factors can affect the employment level of a firm or industry. Increases in labor costs, decreases in transportation costs in competitive units, and reductions in local demand all weaken the ability of the firm to maintain employment, and none of these changes is necessarily due to a change in government policy.

While the adverse effects of a change in government policy tend to be the largest for weak firms, the effect of the policy change, itself, might be very small relative to the adverse effect of other factors. Because it is difficult to accurately attribute the loss of jobs to each factor, a policy change is often assumed to be responsible for all job loss. This makes policy changes which adversely affect weak firms or industries particularly difficult to implement.

#### HOW COMPENSATION CAN BE PROVIDED

##### Reducing the Need for Compensation

The redistributational aspects of a policy change can be altered without recourse to an explicit compensation system. If policy changes can be introduced gradually, adjustment should be easier. Increasing the period of adjustment to a change is particularly important since it will permit attrition to absorb most, if not all, of required employment cutbacks. In addition, firms often possess general entrepreneurial skills and, if the eventual effect of the change is identified early, they can sometimes change their product line. Similarly, if there is an early warning that a change will occur, the local community may be able to attract new firms which can take advantage of the trained labor and physical resources which will become available.

A policy change can also be timed to coincide with particular periods where adjustment is likely to be least costly. Change should be easier to adopt during generally prosperous times or when the industries on which it is focused are especially strong or growing. For instance, it was a simple matter to eliminate the quota on imported steel during the 1973-74 boom in steel. Restrictions were reinstated during 1977-78 when steel demand was slack.

#### Direct Government Intervention to Reduce Loss

Aside from modifying the policy change, government can intervene directly in the adjustment process to reduce losses by assisting firms to improve their efficiency or by defraying the transitional cost associated with the movement of firms into geographic areas affected by a change. This can be done by providing technical advice, low interest loans, or tax breaks. Such an alternative may be less costly than providing direct aid to workers. Little evidence is available concerning the trade-off, however.

In addition, the government can legislate that firms reserve funds to protect workers from the adverse consequence of job loss. Although this may distribute compensation from losers to losers, it is a method that has been used. Recent legislation to vest pensions is a notable example. A similar type of action would be to mandate severance pay.

#### A Working Compensation System -- Trade Adjustment Assistance

The Trade Adjustment Assistance (TAA) Program, which was part of the Trade Expansion Act adopted during the Kennedy Administration, is one of the few examples of an actual attempt to compensate losers in order to gain a policy change. TAA has two components, one designed to assist industry, administered

by the Commerce Department, and a second to compensate workers, administered by the Labor Department (DOL). The latter program is discussed here.

DOL's TAA program currently includes the following major provisions:

1. To be eligible for benefits, the worker's establishment must be certified as trade impacted.\*
2. An eligible worker receives benefits only if he is unemployed. Benefits equal 70% of prior average weekly earnings up to a maximum equal to the average wage in manufacturing. Benefits are paid for any involuntary unemployment within a year of initial job loss.
3. Benefits are paid by the Unemployment Insurance Systems as a supplement to regular UI.

The adequacy of the compensation system (the extent to which the program provides compensation at least equal to the loss) hinges on two criteria:

- the degree to which TAA payments are adequate compensation for unemployment,
- the degree to which unemployment during the certified period accounts for the total earnings loss.

\*Under the 1962 Act, the program certified establishments where changes in trade policy were judged responsible for permanent layoffs. The Act was liberalized in 1974 so that certification is now given to establishments affected by increases in imports, even if there have been no tariff reductions and only temporary layoffs occur.

Naturally, the adequacy of the program differs for different workers. It is worthwhile considering the adequacy for each of three major groups of workers -- temporary layoffs, permanent layoffs from low-wage industries, and permanent layoffs from high-wage industries.

#### Temporary Layoffs

Currently, workers who are temporarily laid off make up by far the largest group of recipients. Compensation is almost certainly adequate for most workers in this group. Unemployment is the major source of earnings loss and, at least for those workers receiving 70% of prior earnings (those receiving less than the maximum payment), the utility value of the payments is probably equal to, if not greater than, the value of prior earnings. The TAA program replaces more than 70% of lost utility because the benefits are tax free, the increase in free time is valuable, and expenditures associated with working, such as transportation costs, are eliminated. Workers who receive the maximum payment have a lower replacement ratio. This reduction, however, is somewhat offset because these workers are in higher tax brackets and the benefits are tax free.

Replacement ratios tend to average very close to 70% because few workers receive the maximum benefit. Layoffs tend to affect workers with less seniority and thus lower earnings. Also, import competition is often strongest for relatively low wage industries, such as textiles.

For all workers, TAA pays for all unemployment occurring during the certification period, not just the portion generated by import competition. This provision of the program increases the likelihood that TAA replaces more than the workers' loss from import competition.



### Permanent Displacements From Low-Wage Industries

The TAA program most likely provides adequate compensation for workers who are permanently laid off from low-wage industries, as well. The PRI study of earning losses in manufacturing industries showed that almost all the losses are associated with unemployment in the year following separation. In addition, many of these workers have low tenure throughout their careers. They are accustomed to searching for work and probably anticipate experiencing considerable unemployment and having to search for work every few years, regardless of TAA protection. Just as with temporarily laid off workers, the TAA program compensates for all unemployment, not just anticipated unemployment generated by import competition. Finally, a considerable fraction of these workers may receive substantial "over-payments" because they place a high value on non-market time and delay their decision to return to work or to formally withdraw from the labor force because TAA benefits are available. "Moral hazard" is not a serious problem for temporary layoffs since the firms set the duration of unemployment.

### Permanent Displacements from High-Wage Industries

The TAA program clearly provides proportionately less compensation for workers who are permanently laid off from high wage industries than the other two groups. The PRI study showed that, in many high wage industries, less than 50% of the total loss was due to unemployment in the first year following separation. High-wage workers often anticipate remaining at their current jobs until retirement. Thus, job search and adapting to a new job is often both completely unexpected and unusually onerous. These workers are also considerably more likely to be affected by the limit on the maximum payment. Finally, high-wage workers often have substantial training

which may deteriorate with unemployment. The lack of adequate compensation for high wage, highly unionized workers who lose their jobs is a major source of dissatisfaction with the TAA program. Political expediency and perception of fairness tend to support providing additional benefits for these workers. Apparently, redistributational considerations play a significant role in determining compensation policy.

The preceding discussion focused on whether compensation was adequate for different groups of certified workers. The certification process itself causes some inequities. All workers who are laid off in a certified plant are eligible, including those who would have been laid off or left even in the absence of increased import competition. On the other hand, workers must apply for certification and since some workers are unaware of the program, not all eligible plants become certified. In addition, only plants that close or suffer large-scale layoffs are eligible for certification. Workers who temporarily or permanently lose their jobs in plants that are less severely affected are not eligible for payments.

Finally, it is worth noting that the costs of the original TAA program, both the payments and the operational costs, were probably far smaller than the gain to society from reducing trade restriction.

The use of the existing UI system to distribute benefits greatly reduced administrative costs, and the case-by-case weighing of certification of firms limited the number of unintended workers who became entitled.

Because of complaints about slowness of payments and about deserving groups who were not compensated under the original act, the 1974 act legislated more timely payments to a wider



range of workers. Only time will tell whether the 1974 adjustments have increased the costs of the program beyond the possible returns to society.

#### SUMMARY

Adverse distributional effects are a major impediment to what otherwise would be regarded as beneficial policy change. The use of compensation programs to solve distributional problems has long been ignored but is gaining greater acceptance. There are three major criteria for deciding who should receive compensation: political, social, and legal. Compensation is most likely to go to groups with political clout, those deemed particularly in need of aid, and those whose claim appears fair. Earnings losses are a relatively good measure of what would be "fair" compensation but the losses vary with the characteristics of the workers and the job. Older, high-wage, high-tenure workers tend to lose the most. One compensation system, which is currently in operation, is Trade Adjustment Assistance. The program is not perfect. It distributes benefits to some who have no loss and denies benefits to some who do lose. It probably pays too much to some, particularly to those with no strong work attachment, but too little to others, particularly those who lose high-wage jobs and those who have relatively specific skills. Nonetheless, on balance, the program has been reasonably successful in handling the extremely difficult and complex task of providing compensation which is reasonably fair to both those adversely affected and society at large.

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